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General Manager
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By email to AERinquiry@aer.gov.au

Profitability measures draft position paper

Dear Mr Anderson,

I want to thank you for the opportunity to present at the Profitability Measures Review Public Forum (the Forum) held on 16 May 2018 in Sydney. I also want to apologise for not having provided a submission in response to the Australian Energy Regulator's (AER) *Profitability measures for electricity and gas network businesses: Draft position paper April 2018* (the Paper). We made a submission to the AER's Discussion Paper for this review (http://energyconsumersaustralia.com.au/wp-content/uploads/Profitability-measures-for-regulated-energy-networks.pdf)

Energy Consumers Australia is the national voice for residential and small business energy consumers. Established by the Council of Australian Governments Energy Council (Energy Council) in 2015, our objective is to promote the long-term interests of energy consumers with respect to price, quality, reliability, safety and security of supply.

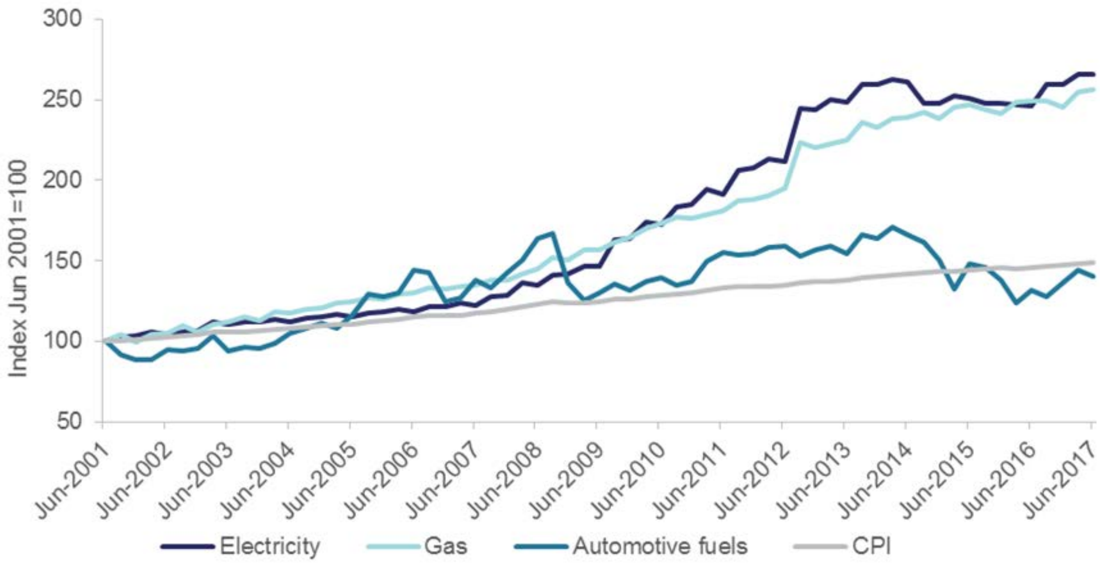
The achievement of the long-term interests of energy consumers requires best practice regulation of the natural monopoly network businesses. Best practice is generally agreed to be some form of incentive regulation whereby the network providers are guaranteed a return on their efficient costs but can generate extra returns by driving for efficiency in expenditure.

Best practice also entails reviewing the consequences of previous regulatory decisions, and this is the purpose of profitability reporting. Energy Consumers Australia supports in general the use of multiple profitability measures and specifically supports the choice of measures included in the Paper. The AER should not only provide the profitability reports but also provide comparisons and analysis.

Context

As we outlined at the Forum electricity and gas price rises over the last decade have outstripped the growth in the CPI and even the price increases in automotive fuels (see Figure 1).

Figure 1: Energy price indices (Source: nvironment.gov.au)



At the same time consumers are not satisfied with the value from money from their electricity (and to a lesser degree) gas services; it is given the lowest rating of all the services examined in our Energy Consumer Sentiment Survey. Our survey also reveals a low level of confidence that the market overall is working in consumers long term interests. (These results have been consistent across all our surveys (http://energyconsumersaustralia.com.au/projects/consumer-sentiment-survey/)

As the Australian Competition and Consumer Commission identified in its Retail Electricity Price Inquiry Preliminary Report network costs account for between 40 and 50% of retail bills and have contributed 40% of the increase in prices. As acknowledge by Energy Networks Australia's Garth Crawford at the Forum, profitability reporting can build trust and confidence can build trust and confidence in the regulatory regime and the market.

When discussing profit, it is important to acknowledge that the term has different meanings in different contexts. What an accountant calls 'profit' an economist regards as being mostly the return to shareholders on their invested capital. For an economist, profit is only that which is left after we allow for a reasonable return to shareholders for their investment. But also, just like cholesterol, there is good profit and bad profit. Bad profit – also called economic rent – is the profit earned by a business with market power being able to increase prices without losing customers to competitors. Good profit is the reward for innovation, from discovering a way to operate at lower cost or add extra benefits to customers that they will pay for.

Incentive regulation is designed to promote good profits while restricting bad profits. Consumers want investors to get an appropriate return on their investments and to get rewards from innovation.

Profitability Reporting

Good regulatory practice requires that a regulator should review the consequences of their decisions; the regulator needs to be focused on outcomes not just processes. A core element of the Australian approach to incentive regulation is the building block approach to determine allowed revenue and return on capital represents about 50% of that.

However, actual firm profitability is based on a number of other factors including returns from non-regulated aspects of the business, and outcomes on various incentive schemes. There are in effect three different incentive mechanisms in place. The first are explicit outcome-based incentives in the STPIS and MDIS. The second are the efficient operation incentives for opex and capex, the EBSS and CESS respectively. These two schemes are designed to provide the network business with 30% of the saving and consumers the remaining 70%. Finally, the regulated business can outperform both the allowed rate of return and the taxation allowance. Both of these are set at the upper limits of a range of efficiency and none of the outperformance achieved by the business is shared with consumers. (Note, the fact that Government owned networks seem to be paying excessive tax could be more effectively characterised as a hidden dividend).

Meanwhile the approach used by the regulator to determine he appropriate allowed rate of return is driven, in part, by estimation of the market's estimation of the value of these firms based on all the value streams of the business. However, apart from the returns from unregulated businesses, all the elements that determine the actual performance – the allowed rate of return, the allowed opex and capex, the taxation allowance and the incentive schemes – are determined by the regulator.

It is therefore important that the cumulative effect of these decisions be assessed through profitability reporting. Prior to undertaking that reporting it is unclear which aspects of the framework might be most important to review.

Part of this assessment is the comparisons that need to be made. The first and most obvious comparison to make is between expected and actual returns; are the various elements working as intended. The second is comparison between providers; most importantly are there parts of regulatory design that are discriminatory. Finally, and most importantly for consumer confidence, is comparison of returns against other sectors.

This breadth of comparisons and the complexity of the revenue determination process provide the strong basis for using more than one profitability measure. We support the AER's choice of measures while recognising the complexity hat some introduce, primarily the difference between statutory and regulatory accounts.

As the Consumer Challenge Panel representative at the Forum, Eric Groom, stated consumers require analysis of the profitability reports, not just reporting. This includes providing comparisons with other sectors.

Conclusion

The value of the profitability measures will be revealed in use. Alternatively stated, there are limitations to how effective evaluation of alternative approaches can be as a purely theoretical exercise. We encourage the AER to move swiftly to issue the required Regulatory Information Notices. But we also encourage network businesses to assist the AER in making profitability reporting effective.

Yours sincerely,

David Havyatt

Senior Economist